Ontario

# FIRST REPORT

# the Royal Commission on Petroleum Products Pricing

September 30, 1975

TO HER HONOUR THE LIEUTENANT GOVERNOR:

May it please your Honour, I, the Commissioner appointed on August 1st, 1975, in accordance with the terms of the Order-in-Council 1998/75 of July 16th, 1975, to inquire into and report upon petroleum products pricing, beg to submit respectfully the following first report for your Honour's consideration.

Claude M. Isbister.

Commissioner

September 25, 1975

# FIRST REPORT

## THE ROYAL COMMISSION

## ON

## PETROLEUM PRODUCTS PRICING

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# CHAPTER 1

## SUMMARY

1.1 Since time is of the essence, it is appropriate to begin with this subject. This first report of the Royal Commission on Petroleum Products Pricing is required by the end of September.

1.2 A sense of urgency attended the formation of the Commission. The Government of Ontario announced in early July that it intended to establish the Royal Commission, and passed legislation effective July 4 freezing the prices of petroleum products at their existing levels until September 30. These actions followed the authorization by the Federal Government on June 23 of a $1.50 per barrel increase in the price of crude oil on July 1 and an equivalent increase in the price of petroleum products on August 15; at the same time it imposed an immediate special excise tax on gasoline of 10 cents per gallon. The price freeze did not of course apply to the latter tax.

1.3 The September 30 date was set in July to enable the Government to consider the report in connection with the possible expiration of the price freeze. On September 7, however, the Government extended the freeze until November 15, stating that this was to provide an extra 45 days for consideration of the report by officials, the Cabinet and the Legislature. The date of the report was not changed, nor did the Commission request this.

1.4 Appointments became effective and work commenced at the beginning of August, with about 60 days for this first stage. It has been necessary to concentrate on the most urgent of the terms of reference, which pertain to inventories and certain price changes. To meet the deadline, the Commission has set aside various matters for later inquiry, and streamlined methods of investigation. This has imposed certain constraints upon all the participants in the process, who have been understanding and cooperative. With more time, the report could have been further polished, but its substance would hardly have been subject to much change. It may be added that the conclusions reached are not dependent to any material extent upon information divulged at the several sessions held <u>in camera</u>.

1.5 On June 30, 1975, inventories available to Ontario of petroleum products, together with crude oil calculated as product equivalent, are estimated to have been about 45,000,000 barrels, higher by 11 % than at the same date in 1974. These inventories were equivalent to about 107 days of supply. The inventories available on September 30 are likely to total about 49,000,000 barrels, so that an increase of about 9% is in prospect during the latest three months. This supply would represent an increase of 6.5% over September 30, 1974.

1.6 There is clearly some appreciable scope for variation from one time to another in quantities of oil and products destined to Ontario and held here. The oil economy of the world has been in turmoil. Critical international events of two years ago raised fears about the security of supplies from overseas, and the industry responded by increasing its inventories. Its response may have been reinforced to some extent by speculative incentives, because changes in the price of crude oil were not likely to be downward. There are some strong seasonal fluctuations: stocks of gasoline are increased in the spring and early summer and of heating oil in the autumn, in each case to prepare for peak demands. The growing Ontario market has softened in recent months. For all these forces of change, it appears, nevertheless, that supplies available to Ontario have been relatively stable, and the changes that have taken place in the period do not seem to merit public concern. Whatever the uncertainties and problems attendant upon the price freeze, the industry has maintained inventory levels through September.

1.7 With regard to changes in the levels of inventories, two related but opposite concerns have been expressed: first, that the oil industry might have built up inventories unjustifiably in the expectation of price increases and, second, that it might have diverted supplies away from the Province during the initial period of the freeze. The evidence given by the supply data is to the contrary. While inventories are on the high side, they are not immoderately so, and seasonal marketing considerations apart from any speculative incentives appear to have influenced supplies. In addition, the evidence indicates that supplies to Ontario have not been interrupted during the freeze.

1.8 The interests of consumers of petroleum products are served by the existence of competition that restrains prices. An overall price freeze is a blunt instrument that has a differential impact by company and product. It is self-evident that a price freeze has the earliest and eventually the most extensive effects on those companies with the lowest stocks at the beginning. Among these are to be found several of the relatively small companies on whose continued participation in the market much of the competition depends. It can be seen in Appendix 4-B that individual companies' holdings of stocks are quite widely distributed above and below the averages for the industry. This distribution of stocks enhances the inequities and the discriminatory financial strains, as amongst companies, of a prolonged freeze. It suggests that a long freeze can militate against the interests of consumers by changing the nature of the industry and the market.

1.9 Aside from changes in inventories, questions have been raised about inventories as a whole in relation to prices. The oil companies customarily increase prices of products simultaneously with the price of crude oil, and they would have done so at the beginning of July but for the price freezes of the Federal Government and of Ontario. They argue that virtually the whole of their inventories are a fixed investment and they justify the immediate price increase on this basis. Consumers, however, are aware that the gasoline on hand at the beginning of July was made out of crude oil acquired at the former lower price, and they believe that price increases should indeed have been delayed until the inventories of early July were used up. Each of these positions contained a good deal of truth; within the unique structure of the oil industry, each becomes untenable when pushed to its extreme logical conclusion. For an oil company, a substantial amount of inventory is fixed and irreducible but not the whole of it: the rest is like goods-in-process in any other industry, which vary in quantity, and variation in inventories in the oil industry can be seen in the figures in Appendix 4-B. The length of a price freeze should not in logic be equated with an average days supply figure. There is a real issue in the timing of a price change, and the formulation of a solution is going to be complex and difficult. On the basis of studies to date, the Commission hopes to be able to make a concrete proposal in this connection in the final report, under paragraph (d) of the terms of reference, which refer to procedures to be followed in relation to future price changes. For policy purposes, it is unnecessary to pursue this issue at present because of the duration of the price freeze that has already been ordered.

1.10 Those who wished to force the oil companies to sell the inventories existing at the beginning of July before raising prices can be satisfied that the original 88-day period of the freeze to September 30 was well on the way to achieving this objective. The extension - another 46 days - to November 15 has considerably surpassed the objective. Because of their different inventory levels, some companies made sales during the first price freeze period at prices that involved a cash drain on their Ontario operations, and others are moving into a similar situation in the second period. By now, concern over price in relation to inventory should not be directed as much to previous supplies as to the increasing amounts of products that are being made from crude oil at the new price of $8.00 per barrel and sold at prices fixed by the freeze. Whatever the arguments about "goods on the shelf" in early July, national companies are now making sales in Ontario at the expense of profits after taxes and cash flow. With a view limited to Ontario, it is difficult to go much further than this statement at present. To attempt to do so would lead to examination of such matters as levels of earnings, capital budgets and whether or not the exploration programs of companies whose operations are only partly in this Province are being affected. Some of these matters are beyond the purview of this Commission, and particularly so at this first stage.

1.11 The Commission concludes that the price freeze was of benefit to consumers during a period of time, and that oil companies would be on weak ground in contesting this. As already indicated, the Commission concludes also that a long extended freeze becomes harmful not only to producers but consumers as well, for the reasons given in paragraph 1.6 and because it eventually affects supplies of products. It follows that there is some optimum period for a price freeze of this kind from the point of view of all concerned. Although the Commission has not as yet suggested criteria for determining the appropriate time to end a price freeze, our investigations and analyses indicate that this time has been passed in the present freeze.

1.12 The Commission has not been asked to advise on what action should be taken under the Petroleum Products Price Freeze Act, 1975, but rather to provide specific information that may be deemed relevant to such action. It is apparent in addition that there are some considerations of policy pertaining to the general economic situation in Ontario bearing on such action that are not related to the Commission's terms of reference.

1.13 Also under question in this first report are changes in the prices of petroleum products that may reasonably occur following the freeze and, more particularly, changes other than those directly attributable to changes

in the price of crude oil. Although the Commission collected views from the oil companies as to what their price changes might have been on September 30, these data are now obsolete and it would be adverse to the public interest to publish them. There is a great danger that a Commission of this kind can unwittingly serve as a means of communicating the pricing suggestions of some companies to the industry as a whole, and thus of diminishing competition. This Commission has no desire to become an agency of price fixing in this sense.

1.14 Some comments can be made here about actual cost increases that will be reflected in prices.

(a) Increased cost of crude oil comes to about 4.6 cents per gallon of product.

(b) Cost of additional working capital to finance crude oil at the higher price comes to about .2 cents per gallon.

(c) Some companies are proposing to increase their posted prices to take account of under-realization of these prices, and thus ensure that they will be compensated in full for the increased costs associated with crude oil.

(d) Two companies indicated their intention to impose an extra charge during coming months to compensate themselves for revenues foregone during the freeze.

As far as (c) is concerned, the companies may have a point, but the Commission thinks it doubtful that they can succeed in doing much about their under-realization in such a competitive market as now exists. As far as (d) is concerned, the Commission regards this proposal as a no-go. Quite aside from the conflict with governmental policy that would be implicit in the latter kind of price increase, it could only be made to stick under conditions of monopoly pricing that no company would wish to suggest exist within this Province.

1.15 In conclusion, the Commission has had to think very hard about the extent and the limits of the jurisdiction of Ontario, even during this first stage and with a limited agenda. The facts of life would make this necessary if the terms of reference did not. The oil companies that are organized to do business in Ontario are mainly national in scope and have important international affiliations.

1.16 Ontario has had to stand aside from much of the recent controversy among the governments involved in production, as the largest consumer in the country but not a producer. It is nevertheless useful for the Government to take a broad approach that goes beyond consideration of its own actions because it is sometimes able to make proposals to the other Canadian governments regarding the effects of their actions on this Province. Without implying any desire to widen the terms of reference of the Commission, this is the point of view from which it seems desirable that the inquiries should be made. The Commission must at least be aware of the larger framework if its findings are to be relevant and constructive.

1.17 Unprecedented changes have been taking place in the world economy, centred on inflation and oil, which are in turn related to one another. Consumers have been grievously affected but oil company operations have not been immune. From an economic point of view there was reason in advance to think that Canada was better able than most countries to deal with all this. As it turned out, the solar plexus was not so much economics as politics in a broad sense: the country has been projected into a constitutional crisis that it has not yet learned to handle or manage. There are no easy answers, and all concerned have been caught in a web of uncertainty and dispute over jurisdiction and responsibilities that need to be faced and resolved.

1.18 As explained in Chapter 7, in Phase II the Commission will conclude its work by studying the remainder of its terms of reference. Submissions in Phase I have already addressed some of the issues. Arguments have been put forward for continuation of the free market system in this province, others for divorcement of the marketing function from the integrated producing oil company, and others for regulation of the petroleum industry through some such body as the Ontario Energy Board. It is clear that a wide range of positions must be examined for relevance and substance, and further evidence adduced. It will be useful for the Commission to inform itself of experience and views in other provinces and in the Federal Government.

# CHAPTER 2

## THE COMMISSION

2.1 This Commission was established under The Public Inquiries Act, 1971 by Order-in-Council dated July 16, 1975 (No. 1998/75) as amended by Order-in-Council dated August 6, 1975 (No. 2126/75), the texts of which are set out as Appendix 2-A. Citing the public's concern about the supply and price of petroleum products in Ontario both at present and in the immediate future, the Order-in-Council instructed the Commission to inquire and report to the Lieutenant Governor in Council on:

(a) inventories available to Ontario of crude oil and petroleum products on the 4th day of July, 1975, and likely to be available on the 30th day of September, 1975, and on such other times as the Commissioner may deem relevant to his Inquiry;

(b) any changes (other than those directly attributable to changes in the price of crude oil) in the price of petroleum products sold in Ontario, within the meaning of The Petroleum Products Price Freeze Act, 1975 which may reasonably occur following the 30th day of September, 1975, or following such later date as is mentioned in any order of Your Honour pursuant to subsection 2 of section 2 of the said Act;

(c) the relationship between any such price changes and the interests of the consuming public of Ontario, particularly, with consideration being given to,

- the adequacy of any petroleum product pricing guidelines established by the Federal Government as they may apply to Ontario;
- working capital requirements of the petroleum industry;
- the continuity of supply in Ontario of crude oil and more particularly petroleum products;

(d) consideration as to procedures that might be followed in relation to future changes in the price of crude oil.

2.2 The Commission was instructed to submit a first report not later than September 30, 1975, with a final report to follow as soon as practicable. In short, the terms of reference are both important and urgent.

In the circumstances, it was deemed necessary to concentrate in Phase I of the inquiry on:

(a) supplies of crude and petroleum products available to the Province at the beginning of July and the end of September;

(b) certain changes of price that may reasonably occur following the price freeze.

These two matters constitute the basis for the first report.

2.3 The Commission began work on August 1st, the effective date of the Commissioner's appointment. (The Commission's staff is listed in Appendix 2-B.) To accelerate the process of collecting the relevant information, the Commission immediately arranged two informal meetings with oil companies operating in the Province. Notices were published inviting the participation of interested persons in public hearings that opened on August 15, 1975. In all, 12 hearings were held.

The public hearings fell into three broad categories:

(a) organizational hearings to determine the participants entitled under The Public Inquiries Act, 1971, to call, examine, and cross-examine witnesses; to interpret the Order-in-Council; and to identify areas where the public interest or the interest of the person affected outweighed the desirability of holding hearings in public;

(b) public hearings directed to supplies and prospective price increases of petroleum products;

(c) submission of concluding arguments.

The Commission's accountants and staff also reviewed with the participants the validity and accuracy of the data submitted and, where necessary, requested supplementary information.

2.4 At the public hearings during the first phase of the inquiry, 25 exhibits were submitted and more than 1,000 pages of testimony were recorded. A list of all persons who appeared at the public hearings is set out in Appendix 2-C. Hearings were also held <u>in camera</u>, as discussed below. In addition, the staff conducted a number of informal hearings and investigations, referred to data from Statistics Canada and retained expert economic and accounting advisors; information so obtained was useful in assessing and evaluating other information received on a formal basis, but has not been basic to any conclusions in this report.

2.5 Throughout the course of the inquiry, the Commissioner and staff have been at pains to be available for consultation. It is a matter of regret that there has not been wider public participation in this inquiry. It is worth noting also that no representations were made on behalf of any level of government. The limited participation may have been, in part, a result of the short notice given on the first phase and of the timing; it was, no doubt, due in part to the complex nature of the matters to be investigated. Time will be less of a constraint on participation in Phase II; the second inhibiting factor will remain a problem.

2.6 The nature of the inquiry required that the Commission examine each major company in the petroleum industry as to the inventory position of each of certain specific products and details of prospective pricing policy. The response of the companies, while not entirely consistent, was generally that publication of such information could damage their competitive positions. At the same time, the Commission was concerned that public hearings on these matters, and especially with respect to price, might provide a mechanism for indirect pricing discussion within the petroleum industry, leading to the possible stifling of competition among the oil companies involved. The Commission therefore decided that both the public interest and the interest of the companies affected required that evidence on these topics would not be dealt with publicly. The inquiry proceeded on the basis that matters classified by the Commission as confidential would be received and examined <u>in camera</u> unless later reclassified as public. This reclassification would only occur after the persons affected had been given an opportunity to be heard. When the Commission has completed its inquiry, the exhibits marked "confidential" are to be sealed by the Commission and delivered to the Provincial Archives for retention should proper access to them be required under due authority at some future time. This method of operation has proved successful in establishing confidence in the pro-

tection given information classified as confidential. Throughout this first report, the confidentiality of information thus obtained has been maintained either by the use of algebraic references and percentages or by the use of composite accounts and tables.

2.7 The Commission is satisfied that the public interest has been served by keeping the matters mentioned above confidential. Protecting the confidentiality of this sensitive commercial information has not required the Commission to compromise in any of its findings or to restrict any aspect of this report.

2.8 The matters now classified as confidential will be considered again in Phase II of the inquiry. It is possible that, as the Commission and the participants develop a fuller understanding of the needs of the inquiry and the degree of confidentiality required for specific types of information, the scope of public hearings may be broadened accordingly, and the scope of _in camera_ hearings narrowed.

2.9 In this report, chapter headings have been used, as have explanatory headings at various places in the text. These are for convenience of reference only and are not to be considered as expressing or implying conclusions on the part of the Commission.

# CHAPTER 3

## PLACING THE PETROLEUM INDUSTRY IN PERSPECTIVE

3.1 The petroleum industry is international in structure and a major factor in world trade, so that worldwide trends in the industry have a major significance for domestic producers and economies. The rapid escalation in world crude oil prices over the last two years has been reflected in Canadian crude prices and, more importantly, has altered the relationships of governments in Canada with the oil industry and with each other. As a result, Canada today faces new complexities and uncertainties.

3.2 This chapter is intended to provide a brief perspective on the importance of the petroleum industry for Ontario. This background information has been gathered from Statistics Canada and other sources, and has not been introduced as evidence at the Commission's hearings.

3.3 To provide a basic understanding of the petroleum industry in Canada and of its place in Ontario, certain background information is reviewed below. The data presented include figures on:

- (a) petroleum reserves;
- (b) refining capacities;
- (c) pattern of supply;
- (d) consumption of petroleum products;
- (e) petroleum products prices;
- (f) capital investment levels;
- (g) crude oil price changes.

### PETROLEUM RESERVES

3.4 Canada plays a relatively minor role in the world petroleum industry. Daily production of crude in Canada represented about 3% of the average total daily world production of 55,000,000 barrels in 1973, and Canada's proven oil reserves amounted to only 1.4% of the world's total proven reserves.

3.5 The reserve position for the world at this time is dominated by relatively few major fields; a field considered major in the industry has reserves of 10 billion barrels or more. None of the Canadian fields can be considered in this category. In fact, the total proven Canadian reserves almost equal the level of a single major oil field. Nothing new can be said here about the tar sands, heavy oils and discoveries that remain to be made, except that they may have great potential.

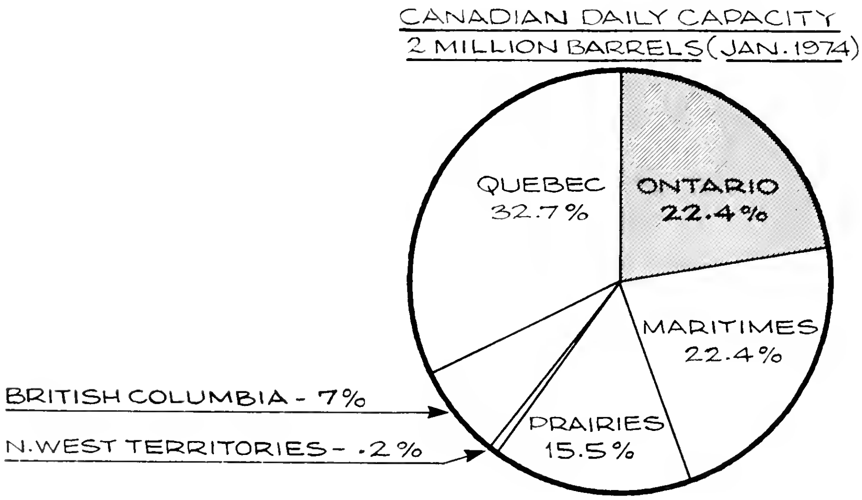
3.6 Figures of estimated quantities of proven reserves cannot be accepted unequivocally. The level of Canadian reserves and the life index generally accepted in the industry are . . .

| LOCATION | Proven Reserves December 1973 | 1973 Net Production | Life Index 1973 Rates |
|---|---|---|---|
| | Million Barrels | | (years) |
| Northwest Territories | 41.9 | 1.0 | 40.5 |
| British Columbia | 205.1 | 21.5 | 9.8 |
| Alberta | 6,785.0 | 511.7 | 13.2 |
| Saskatchewan | 588.7 | 85.4 | 6.9 |
| Manitoba | 43.6 | 5.1 | 8.6 |
| Ontario | 10.4 | .8 | 12.7 |
| Eastern Canada | .1 | .0 | 7.7 |
| TOTAL | 7,674.8 | 625.5 | 12.2 |

Source: Canadian Petroleum Association 1973 Statistical Year Book

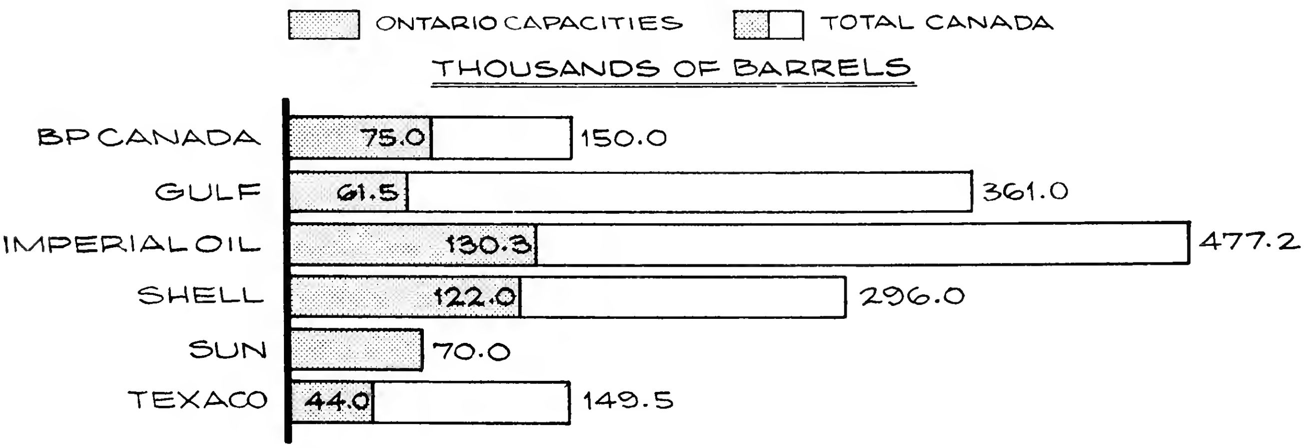
## REFINING CAPACITY

3.7 Although Ontario accounts for a negligible part of Canadian crude oil production, the province plays a major role in Canadian refining capacity. The total refining capacity in Canada was 2,000,000 barrels per day in 1974. Ontario accounted for approximately one-quarter of this capacity . . .




Source: The Financial Post Survey of Oils 1975

3.8 All of the refining in Ontario is done by six major oil companies. The proportion of their total refining capacity in Ontario varies to a considerable degree . . .

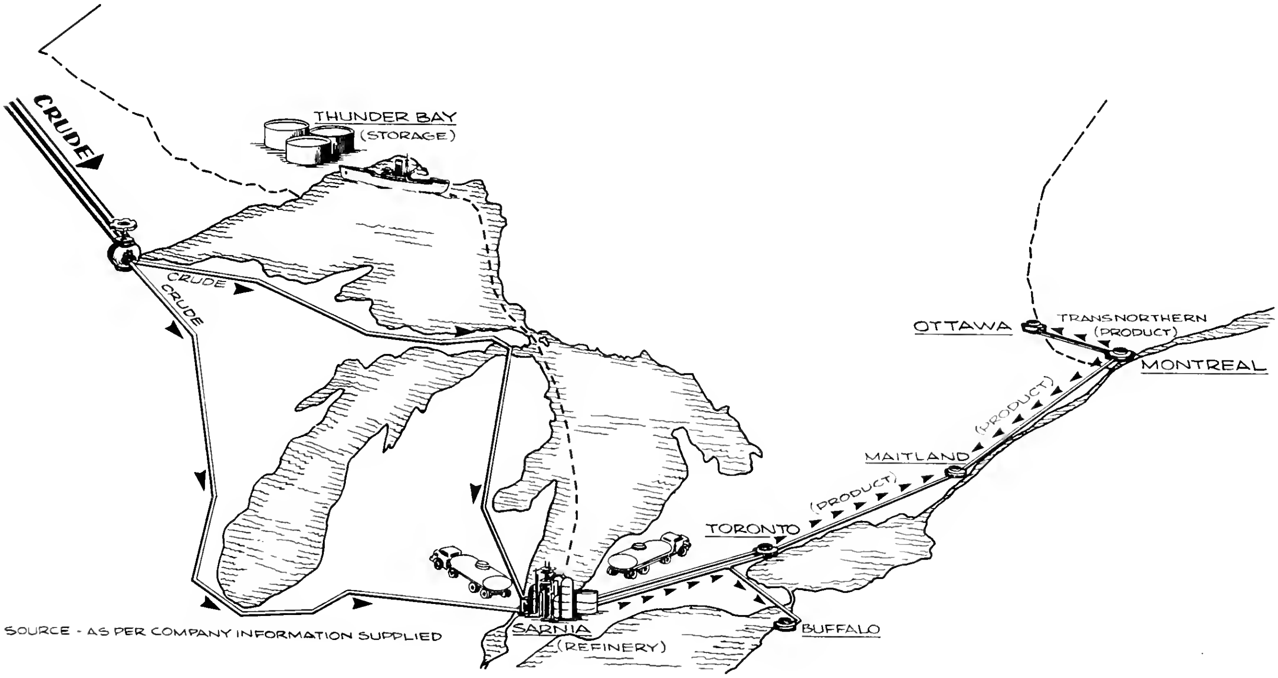



SOURCE - COMPANY ANNUAL REPORTS & FP 1975 SURVEY OF OILS

3.9 A major addition to the refining capacity in Ontario will be the new Texaco refinery at Nanticoke, scheduled to come on stream in 1977. This refinery, with a capacity of 95,000 barrels per day, will boost present Ontario capacity by approximately 20%.

## SUPPLY PATTERN FOR ONTARIO

3.10 Virtually all crude oil refined in Ontario is supplied from Western Canada by the Interprovincial Pipe Line system, which enters the Province at Sarnia. The bulk of the petroleum products for the Ontario market are produced by Ontario-based refineries and distributed across the Province in a variety of transportation modes . . .



SOURCE - AS PER COMPANY INFORMATION SUPPLIED

3.11 Some products are refined outside Ontario and transferred* into the Province through sections of the Trans Northern Pipeline that supply the Ottawa Valley. These products are refined in Montreal East, in refineries that are fed with imported crude oil.

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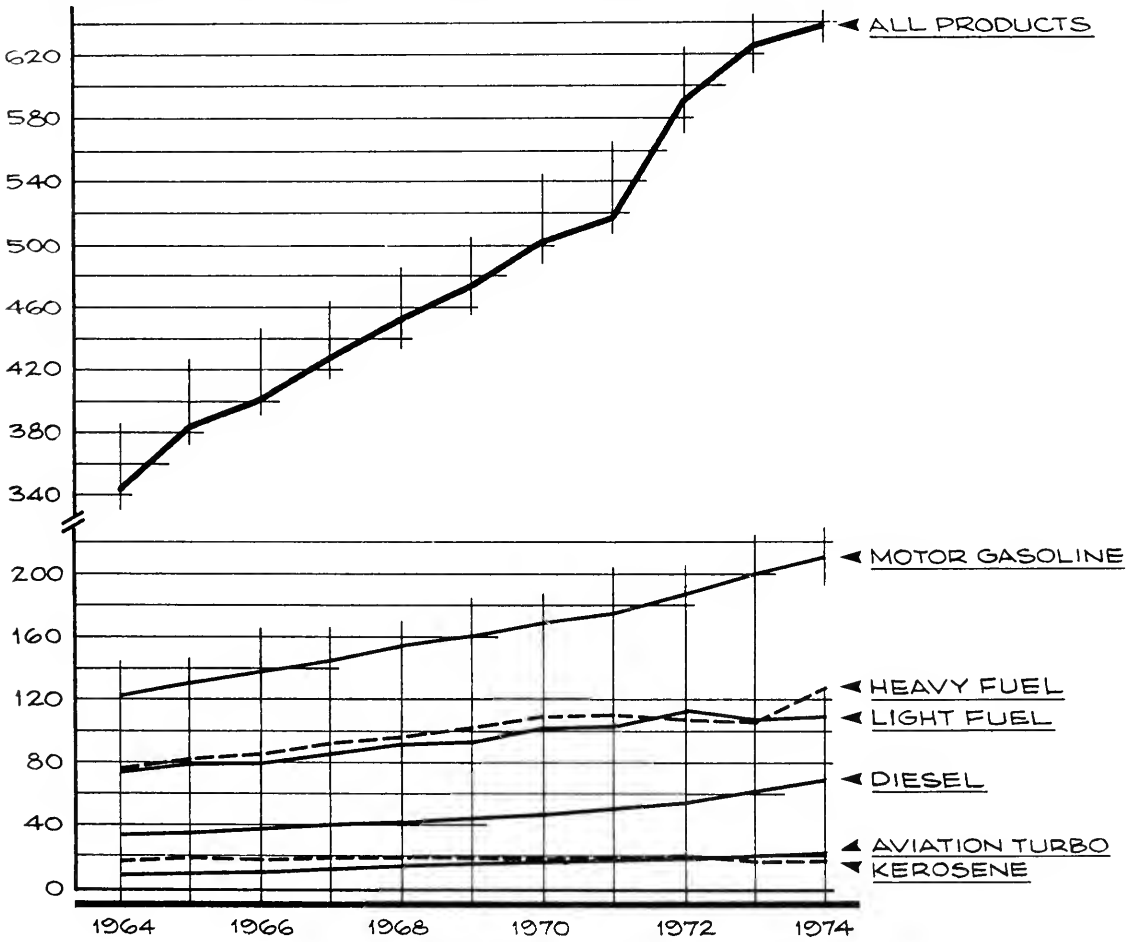
* - "Transferred" refers to the movement of Canadian crude or product within Canada, whereas "imported" refers to the movement of non-Canadian crude or product into Canada.

## PETROLEUM PRODUCTS CONSUMPTION

3.12 The consumption of petroleum products has increased significantly in Canada over the last decade. The leaders in terms of percentage growth have been aviation turbo fuel (200%), diesel fuel (108%) and motor gasoline (72%)*. Even with the dramatic increases in consumption of these products, however, motor gasoline still accounts for one-third of total consumption - the largest share for any single product . . .

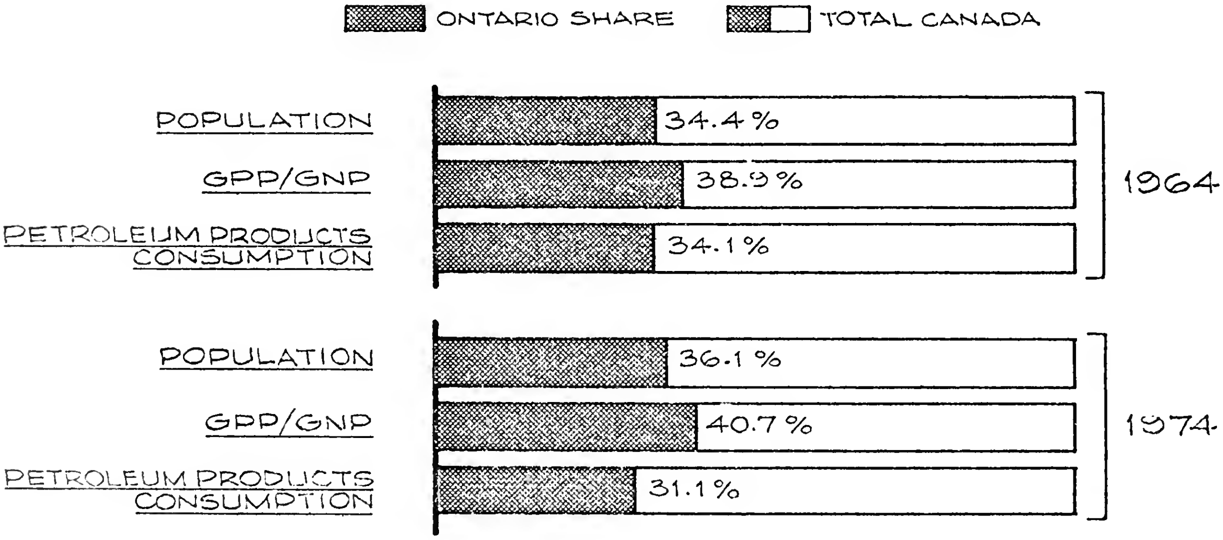
CANADIAN CONSUMPTION - MILLIONS OF BARRELS




SOURCE - STATISTICS CANADA, CAT. NOS. 57-207, 57-505, 45-004

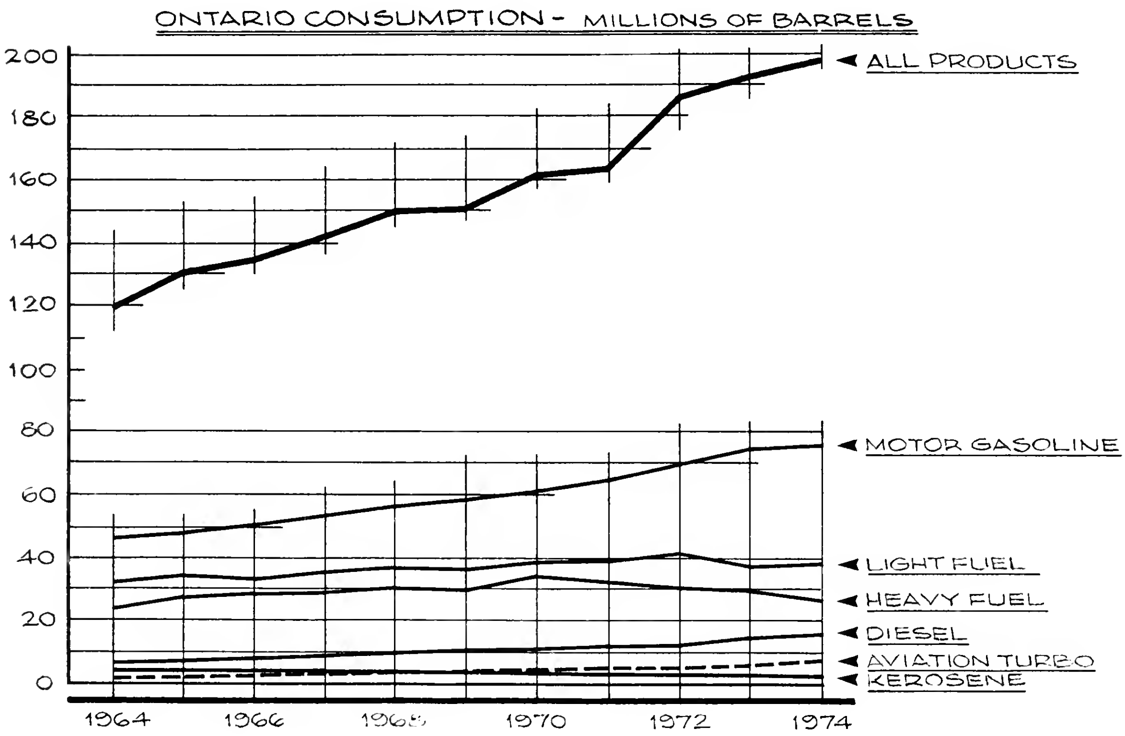
* - See Appendix 3-A for descriptions of categories of petroleum products.

3.13 Although Ontario's share of Canada's population and of the country's industrial activity has increased by about 2% over the last ten years, provincial consumption of petroleum products as a proportion of national consumption has actually decreased . . .



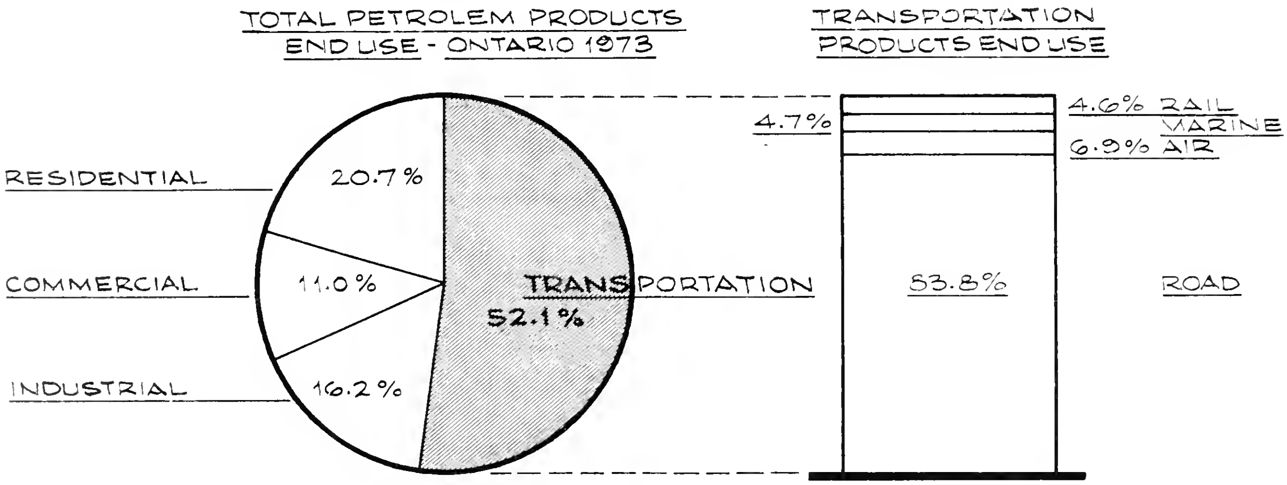

SOURCE - STATISTICS CANADA, CAT. NOS. 57-207, 57-505, 45-004.

3.14 Within Ontario, the consumption of petroleum products has increased by about 65% over the last decade. As with the national consumption, aviation turbo fuel (263%), diesel fuel (140%) and motor gasoline (65%) have been the growth leaders. By far, motor gasoline accounts for the largest single product share (38%) of total provincial consumption of petroleum products . . .




SOURCE - STATISTICS CANADA, CAT. NOS. 57-505, 57-207, 45-004

3.15 Classified by end use, transportation accounted for more than half of Ontario's petroleum products consumption in 1973. Within this category, road transportation accounted for more than 80% of the total . . .




SOURCE - SHELL CANADA, SUBMISSION TO THE ROYAL COMMISSION ON PETROLEUM PRODUCTS PRICING, CHART NO. 27

## PETROLEUM PRODUCT PRICES

3.16 Although prices of petroleum products have risen over the past ten years, their part in total manufacturing costs continues to be small. In Ontario during 1974, energy accounted for only 1.4% of total manufacturing costs. Petroleum products accounted for less than one-quarter of the energy total in the same period, bringing petroleum products costs to less than 1% of total manufacturing costs. Furthermore, between 1970 and 1974, energy as a component of total manufacturing costs decreased.*

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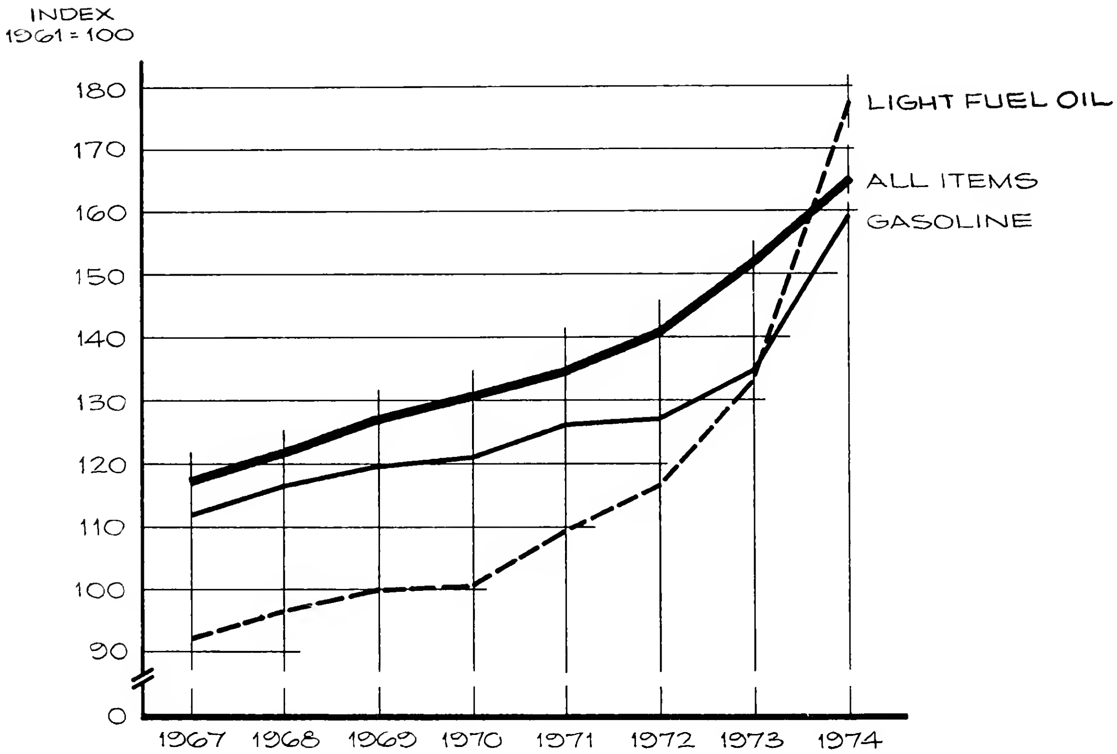
* - Facts presented in this paragraph were derived from an analysis by Waverman Economic Analysis.

3.17 In relation to consumer expenditures, however, gasoline and light fuel oil prices have been increasing at a rate faster than that of the aggregate consumer price index, particularly in recent years . . .




SOURCE - STATISTICS CANADA, CAT. NO. 62-002

## CAPITAL INVESTMENT

3.18 A striking feature of the petroleum industry is its capital intensity. Large capital commitments are required to finance pipelines connecting oil fields with markets and to finance refineries. A continuous program of exploration for new oil fields is necessary to ensure a continuity of crude supply for the industry. The annual level of exploration expenditure and capital investment by Canadian-based oil companies continues to be considerable . . .

| | $ 000,000's | | | | |
|---|---|---|---|---|---|
| | 1970 | 1971 | 1972 | 1973 | 1974 (e) |
| Exploration and production | 650 | 725 | 850 | 1,000 | 1,150 |
| Pipelines | 35 | 75 | 60 | 80 | N/A |
| Refineries | 240 | 210 | 325 | 290 | 335 |
| Chemical plants | 25 | 15 | 10 | 15 | 25 |
| Marketing | 160 | 150 | 150 | 155 | 160 |
| Others | 25 | 20 | 30 | 35 | N/A |
| TOTAL | 1,135 | 1,195 | 1,425 | 1,575 | |

Source: Capital Investment of the World Petroleum Industry: Chase Manhattan Bank

## CRUDE OIL PRICE CHANGES

3.19 The Federal Government has adopted a policy of sheltering domestic consumers from the full impact of the abrupt increases in the world prices of oil. The price of a barrel of domestic crude was frozen at $3.80 in 1973; and it has been allowed to rise in two jumps to $6.50 and again on July 1 to $8.00, approximately $3.50 below then current international prices. A corresponding export tax raises the prices of allowable oil exports to world levels, while an import subsidy enables importers of offshore crude to pay the same price as purchasers of domestic crude. It appears as this report goes to press that a further increase in the world price of crude may be imminent.

# CHAPTER 4

## INVENTORY AVAILABLE

4.1 The inquiry focussed on the question of which inventories can be considered available to Ontario at any given time. Ontario is dependent for its petroleum supplies on some of the longest supply lines in the world, including the Interprovincial Pipe Line from Alberta and the trans-oceanic tanker routes from the Persian Gulf, West Africa and Venezuela. The definition of "available to Ontario" was based on finished product equivalents, and included all inventories physically in Ontario and all inventories in the supply network outside of Ontario that were actually or forecast to be destined for Ontario. (For a detailed definition of "available to Ontario" see Appendix 4-A.)

4.2 On the basis of its study of the industry supply information, the Commission has been able to make the observations below.

(a) The total inventory figures presented in this report are a reasonable estimate of petroleum product inventories available to Ontario.

(b) The level of inventories on June 30, 1975 was not excessive given the prevailing market conditions.

(c) The industry has not interrupted its supply of crude oil and petroleum products to Ontario as a result of the price freeze.

(d) Basing decisions on average days supply figures has a discriminatory impact.

These observations are discussed in the following sections.

## TOTAL INVENTORY FIGURES

4.3 The information on inventories was gathered from ten reporting companies (Appendix 4-B). While the Commission has relied upon these companies for basic inventory data, it has been able to carry out certain broad checks that confirmed the reasonableness and consistency of these data, including checks against information submitted to Statistics Canada.

4.4 There are certain inventories reported to Statistics Canada that are not included in the figures presented in this report and are not considered to be of sufficient magnitude to affect the conclusions reached. These are principally agency and dealer inventories owned by the reporting companies and inventories of a few smaller companies. Further, there are inventories held by independent dealers and distributors that were not reported to Statistics Canada or the Commission. The Commission has no detailed estimates of these inventories.

4.5 A summary is presented below of inventories available to Ontario at June 30, 1975 together with the number of days supply represented by those inventories. (Additional information on inventories and days supply is provided in Appendix 4-B.) There was a sizeable range in the average days supply in each product category.

ESTIMATED INVENTORIES AVAILABLE TO ONTARIO AT JUNE 30, 1975*

| Products** | Barrels (000's) | Days Supply*** Average | Range High | Range Low |
|---|---|---|---|---|
| Propane | 300 | 62 | 84 | 46 |
| Motor Gasoline | 17,500 | 72 | 94 | 30 |
| Aviation Jet Fuel | 2,000 | 71 | 100 | 45 |
| Middle Distillates | 19,200 | 169 | 184 | 32 |
| Heavy Fuel Oil | 6,000 | 96 | 173 | 19 |
| Total Barrels | 45,000 | | | |
| Days Supply | | 107 | 180 | 30 |

* - The Commission selected June 30, 1975 as a reporting date, instead of July 4, 1975 as set forth by Order-in-Council, because it facilitated the gathering of information, being at or close to a normal accounting date. There is no reason to believe that the industry total inventories would have changed materially between the two dates.

** - The inventory figures presented in the report relate to those products subject to the Petroleum Products Price Freeze Act, 1975.

*** - The basis for calculation of average days supply figures is explained in Appendix 4-B, Notes 2 and 3. The high/low range of days supply shown above is taken from figures submitted to the Commission by the reporting companies.

## CHANGES IN INVENTORY LEVELS

4.6 While the recent inventory levels seem to have been higher than desired by the industry, they have not been excessive. Inventories grew by 11% from June 30, 1974 to June 30, 1975, and they are forecast to grow by 6.5% between September 30, 1974 and September 30, 1975.

### CHANGES IN INVENTORY LEVELS

| Year | Date | |
|---|---|---|
| | June 30 000 bbls. | September 30 000 bbls. |
| Total Inventories - 1974 | 40,500 | 46,000 |
| Total Inventories - 1975 | 45,000 | 49,000* |
| Percent Increase | 11% | 6.5% |

4.7 While the increase in total inventories from June 1974 to June 1975 was greater than would normally be expected, this can be attributed to reduced product demand. The mild winter of 1974-75 left the industry with unexpectedly high levels of heating fuel inventories. In addition, rising oil prices and energy conservation combined to further reduce demand.

4.8 Inventory levels of petroleum products in Ontario normally fluctuate according to seasonal demand, for example heating oil in anticipation of winter sales. The fluctuations in sales and inventory levels of middle distillates over a year are illustrated in Appendix 4-C. The chart shows that during summer, when demand for motor gasoline is high and middle distillates low, inventories of middle distillates increase. This happens, in part, because the refining process produces both motor gasoline and middle distillates (as well as other products) as a matter of course, and there is only a limited variability in output of individual products obtained from each barrel of crude oil processed.

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* - Inventory figures provided for September 30, 1975 are estimates prepared by the reporting companies based upon their best business forecast available to the date of reporting (August 20, 1975).

4.9 It has been pointed out to the Commission that the ability of the oil industry in Ontario to build up inventories is constrained by available storage capacity. The unutilized storage capacity varies throughout the year according to production rates and demand patterns. While two of the reporting companies' inventory levels were on the high side at June 30, 1975, and while companies can take speculative positions, it does not appear that any of the inventory levels is higher than can be explained on more objective grounds.

## CONTINUITY OF SUPPLIES TO ONTARIO

4.10 The forecast of supplies for September 30, 1975 indicates to the Commission that the oil companies were planning to maintain normal inventories. The Commission therefore observes that the industry has not changed its supply plans for Ontario from normal business practices during the first 88 days of the price freeze.

## USE OF AVERAGE FIGURES

4.11 The figure of 107 days of supply as of June 30, 1975 that is presented in this report is an average for the industry as a whole. The average figure is valuable in providing an overall view of the inventory situation for the industry and for calculating the financial implications of a price freeze. As discussed later, in Chapter 5, this average figure is not valuable for establishing the duration of a price freeze. Furthermore, basing a price freeze on an average figure has a discriminatory impact on companies and probably on consumers.

4.12 This discriminatory impact is indicated in the following table, which shows that there is considerable variation among companies of days supply for all products.

CLASSIFICATION OF COMPANIES BY
NUMBER OF DAYS SUPPLY AVAILABLE
TO ONTARIO ON JUNE 30, 1975

| No. of Days Supply | Motor Gasoline | | Middle Distillates | | Heavy Fuel Oil | | All Products | |
|---|---|---|---|---|---|---|---|---|
| | Cos. | Bbls. (000's) | Cos. | Bbls. (000's) | Cos. | Bbls. (000's) | Cos. | Bbls. (000's) |
| Up to 45 | 2 | 200 | - | - | 2 | 600 | 2 | 800 |
| 45 to 88 | 6 | 13,400 | 2 | 100 | 5 | 3,500 | 4 | 17,600 |
| 88 to 134 | 1 | 3,900 | 2 | 1,900 | - | - | 3 | 22,300 |
| 134 to 180 | - | - | 4 | 10,000 | 1 | 1,900 | 1 | 4,300 |
| Over 180 | - | - | 2 | 7,200 | - | - | - | - |
| TOTAL | 9 | 17,500 | 10 | 19,200 | 8 | 6,000 | 10 | 45,000 |
| Average Days Supply June 30, 1975 | 72 | | 169* | | 77 | | 107 | |

Two of the smaller companies had less than 45 days supply on June 30, 1975 and have suffered most during the price freeze. Even among the larger oil companies there is considerable variation in days supply, with five companies falling below the average of 107 days, one company as low as 79 days, and only one company whose inventories are expected to last beyond the price freeze of 134 days.

4.13 The discriminatory impact of average figures also applies to companies that specialize by product. Some companies specializing in home heating fuels and other middle distillates have inventories purchased prior to July 4, 1975 that might not be sold within 134 days, whereas those specializing in motor gasoline will have sold all inventories purchased prior to July 4, 1975 well before 134 days. For example, evidence submitted

* - Middle distillates show high days supply at June 30, 1975 in part because demand remains low through July, August and September, and then increases sharply. By September, the inventories of middle distillates, although considerably higher (23,900,000 barrels), represent approximately 122 days supply.

to the Commission by the Propane Gas Association of Canada asserted that its members had accumulated stocks of propane when the freeze became effective amounting to no more than 4 to 8 days supply, and that 50% of supplies were purchased outside the Province from areas not affected by the provincial price freeze. In consequence, the members of the association, in order to protect their trade position, have been compelled to absorb any increase in their cost of supply from areas outside of the province where prices have increased.

# CHAPTER 5

# INVENTORY PROFITS

5.1 This Commission was not explicitly directed to report on inventory profits and this issue is only indirectly relevant to the first phase of the work, i.e., to the extent that such profits should be considered in looking at any prospective price increases. The subject is inseparable, however, from the questions of price freezes, timing of price increases and financing of inventories. Because this is so and because much public attention is focussed on the issue, it is dealt with here in some detail.

5.2 When the price of crude oil increases, the inventories in the hands of companies become more valuable. If companies increase prices immediately, they get the benefit of what is called inventory profit; if they delay price increases until the inventories are used up, consumers get the benefit. There are complex matters in this that have normally been resolved by market forces. In this instance, the changes have been so extensive as to involve public controversy and political intervention. This chapter examines the issue of inventory profits in relation to the $1.50 per barrel increase in the price of crude oil authorized by the Federal Government effective July 1, 1975, by presenting:

(a) the respective positions on inventory profits of the consumer and the producer;

(b) the key considerations that guided the Commission in studying inventory profits;

(c) the Commission's findings.

## CONSUMER AND INDUSTRY POSITIONS

5.3 Public concern over inventory profits in relation to all consumer goods has grown in light of the recent high rates of inflation. Debate over inventory profits in petroleum products has become more audible as Canadian crude oil prices have been rising toward world levels. At July 1, 1975, approximately 45,000,000 barrels of crude oil

and finished petroleum products were en route to or in the possession of the refining and marketing divisions of the oil companies in Ontario. This inventory was all acquired at an effective raw material cost of approximately $6.50 per barrel. On that date, the Federal Government increased the price of crude oil by $1.50 per barrel. The basic question is; how soon should that $1.50 per barrel increase in crude oil costs be reflected in higher selling prices for petroleum products ? There are two quite opposite views on this matter: the consumer's and the producer's.

## The Consumer's Position

5.4 Consumers and their advocates are disturbed by the almost instantaneous repricing of products "on the shelf" coincident with a cost increase to the manufacturer or processor. They can understand that prices must rise eventually, but think that any attempt by the producer to pass its increased costs on immediately will result in the producer earning an excess profit on the stocks acquired at the old cost. In the consumer's mind, this is a pernicious ploy. The consumer is left to pay the difference, and sees no adequate reason why the price he pays should not be based on the original costs of the goods.

## The Producer's Position

5.5 A number of submissions from the oil companies have dwelt in particular on inventory profits. They have argued that inventory profits are highly illusory, that they do not constitute profit in the classic sense, and that they only arise because of certain accounting and income tax conventions. Concerning the inventory profits issue in the context of the petroleum industry in Ontario, the companies have made these major points.

(a) Inventories tend to be irreducible because of the nature of the supply and distribution systems and the seasonal nature of product demand, with gasoline sales peaking in the summer and home heating oil sales in the winter.

(b) The inventory of crude oil and refined petroleum products must be maintained at approximately 45,000,000 barrels to ensure a continuous supply of products to the consumer.

(c) To deliver a barrel of finished product to a customer in Ontario, the company must feed an equivalent barrel of crude at the new price into the Interprovincial Pipe Line system in Alberta.

(d) The companies would report an above-normal profit if they were in a position to pass the increased costs along immediately, but only because they are required to compute income for tax purposes using the FIFO (first-in, first-out) method of inventory valuation. If they were instead permitted to use the LIFO (last-in, first-out) method of inventory valuation, they would report no such profits.

## KEY CONSIDERATIONS

5.6 A full understanding of inventory profits turns on three considerations: the economic conditions and the accounting practice in an industry as well as the character of the inventories of the individual company.

5.7 In the view of the Commission, resolution of the inventory profits issue in the petroleum industry requires the separation of two questions. In several submissions, the questions of passing on costs and of financing inventories were intertwined and confused. They are separate and should be kept separate. The question of how much money is required to finance inventories and how it should be raised has no bearing on the question of when and how increased costs should be passed on. No doubt, new levels of inventories have to be financed, and the working capital implications are substantial. But this working capital need not be financed exclusively out of retained earnings, nor is it necessary to accumulate these earnings prior to or during the process of acquiring the new inventories. While the producer might prefer to do so, the Commission does not accept that this approach is the only financing alternative or the cheapest alternative for the consumer.

5.8 The Commission's preliminary investigation of inventory profits leads it to the belief that, in the petroleum industry, the central question is an economic one, and the answer will vary from company to company, according to the nature of the company's inventory function; that is, according to the extent to which the inventory may be regarded as fixed in quantity. The Commission will address this matter in greater detail in the second phase of its work.

## THE COMMISSION'S FINDINGS

5.9 The evidence considered by the Commission on the inventory profits issue leads it to the view that the time when new inventory costs should be passed through in a price increase lies somewhere between the time when a change in the cost of crude oil occurs and the time when the last unit of old inventory is sold. The Commission will continue to attempt to define the optimum point in question. These still emerging findings are discussed below. However, the subject is largely academic at present because the freeze extends beyond the point when all the old inventories will, on average, have been consumed. Thus any inventory profits the companies could have realized have been wiped out.

### The Timing of Product Price Increases

5.10 While there should be an appropriate delay, it appears that crude cost increases should be passed on before the whole of the inventory is sold, because inventory in the petroleum industry has both fixed and variable components.

(a) A substantial portion of the inventories available to Ontario is permanently tied up in pipelines, refineries and tank bottoms. This is a fixed component of the inventory that is required for the basic operation of the system, does not vary with the level of sales, and in many respects is equivalent to a fixed asset.

(b) There is also evidence that companies do plan part of their inventories in response to anticipated sales levels. For example, evidence to the Commission indicates that the industry increased its inventories by about 11% from June 30, 1974 to June 30, 1975, in response to anticipated sales that did not materialize. Several companies have said to the Commission that their current inventory levels are above their base inventory levels and in addition, the seasonal nature of the industry suggests that inventories must to some extent be managed on the basis of sales expectations.

The Inventory
Profit Potential

5.11 Companies could have realized inventory profits if they had been able to raise prices coincident with crude cost increases. The Commission's analysis indicated that companies would have an apparent gross inventory profit of approximately $67,500,000 (45,000,000 barrels at a price change of $1.50 per barrel). Because of Canadian income tax law, the companies would have paid out approximately half in higher income taxes, but retained $33,750,000.

5.12 While the holding of inventory is an advantage to a producer when crude costs rise, and considerably more advantageous than holding cash, inventory profits are not the same as normal operating profits.

5.13 However, because of the price freezes, the industry will not realize inventory profit that it might have derived from the $1.50 per barrel increase in the price of crude oil, and net profits are now being reduced instead.

# CHAPTER 6

## PROSPECTIVE PETROLEUM PRICE CHANGES

6.1 At the start of the inquiry, the Commission requested information from the major integrated oil companies concerning the price changes that they might make following September 30, 1975. It was anticipated that the prospective price changes and the delivery of the first report would be virtually simultaneous.

6.2 The data obtained in this way are being kept in confidence for two reasons. Not only did the extension of the price freeze to November 15, 1975 nullify the information, but it would be contrary to the public interest to publish it. There is a danger that, by publishing the intentions of individual companies with respect to prices, the Commission might turn itself into an effective centre of price fixing. The executives of the companies concerned understandably expressed apprehension on this score when contact was first made with them. The Commission shares this concern.

6.3 The discussion of prospective price changes in this section of the report is therefore restricted to a review of the factors that the companies will take into account in considering the necessity for and the extent of a price increase.

6.4 These factors are:

(a) the federal price guidelines;

(b) the direct and indirect effects of the increased cost of crude oil;

(c) federal sales tax;

(d) "under-realizations";

(e) recovery of cash short-falls;

(f) other cost increases;

(g) prices as between products.

## FEDERAL PRICE GUIDELINES

6.5 An important factor that will govern any changes in petroleum product prices in Ontario at such time as the provincial price freeze is lifted, is the existence of the Federal Government's guidelines on the pricing of petroleum and petroleum products. At present two sets of guidelines are in force, the first of which was issued on February 21, 1975, and the second on July 14, 1975 (see Appendix 6-A)

6.6 The industry in general interprets these guidelines to mean that the only price changes it would initially have been permitted to make if the Ontario price freeze had ended on September 30, 1975, were those directly and indirectly related to the $1.50 per barrel increase in the price of crude oil; the companies would not immediately be allowed to pass on to consumers any other cost increases incurred in their refining and marketing operations.

## DIRECT EFFECT OF CRUDE OIL PRICE INCREASES

6.7 Crude oil is the essential raw material in the production of refined petroleum products. Any change in its cost to refiners flows directly through to the cost of refined petroleum products. Moreover, crude oil is consumed in the production of refined products, so that any price change in refined products must also take into account the cost of the crude oil used in the refining process.

6.8 The Commission calculates that the $1.50 per barrel increase in the cost of crude oil should increase the cost of a gallon of refined product by 4.55 cents. This projection is based on a 94 percent refinery yield and a conversion rate of 35 gallons to the barrel. The projection of a 4.55 cent per gallon increase should be understood as an average cost recovery objective rather than an across-the-board increase in the price of all petroleum products. While the additional 4.55 cents per gallon constitute a new cost component that the producers must recover, the oil companies may well vary their rates of recovery across products depending on the market situation.

## INDIRECT EFFECT OF CRUDE OIL PRICE INCREASES

6.9 In addition to the direct effect on raw material and production process costs, any increase in the price of crude oil has an indirect effect in that an increased amount of capital is required to carry inventories and accounts receivable net of increased accounts payable. This capital can only be raised at some cost.

### Increased Capital Requirements

6.10 In Appendix 6-B, the Commission has set out several analyses showing how the timing of price increases relative to cost increases affect the funding of the industry's increased capital requirements. They can be summarized as follows.

(a) If prices increase the same day that crude oil costs rise, the industry requires $75,000,000 in new financing. Although the consuming public would provide $67,500,000 by way of higher prices, the companies would pay out some $33,750,000 of this $67,500,000 in income taxes. The industry must raise the remaining $41,250,000 from internal funds or from the financial markets.

(b) If selling prices increase 45 days after the rise in crude oil costs, the industry still requires $75,000,000 in new financing, of which $38,500,000 - but only $19,250,000 after income taxes - will be provided by the consuming public, and $55,750,000 will have to come from some other source.

(c) If selling prices increase 90 days after the rise in crude oil costs, the industry again requires $75,000,000 in new financing, of which $9,500,000 - but only $4,750,000 after income taxes - will be provided by the consuming public, and $70,250,000 must be raised by other means.

(d) If selling prices increase 135 days after the rise in crude oil costs, the industry requires $75,000,000 in new financing to cover increased working capital, all of which

must be diverted from other internal opportunities or raised externally. In addition, the 135-day delay will result in reduced profits to the industry of at least $9,750,000 after income taxes. (At least $9,750,000 because forecast petroleum product sales are higher per day for the 45 days ended October 15, 1975, than the average for the 90 days ending September 30, 1975.)

### Costs of Increased Capital

6.11 The annual cost of financing $75,000,000 of increased working capital would be about $12,375,000, or approximately .2 cents per gallon. In arriving at this figure, the Commission had to make an assumption as to what part of the new costs could be financed by debt and what part by equity. For purposes of making this calculation, it was assumed that 75 percent of the costs might be debt financed at a cost of approximately 12 percent per annum, leaving the remaining 25 percent to be equity financed at an approximate pre-tax cost of 30 percent per annum. Thus the weighted average cost would be a pre-tax rate of 16.5 percent. The cost per gallon is based on approximate annual industry sales of 185,000,000 barrels and a conversion rate of 35 gallons to the barrel.

6.12 It is important to note that this .2 cents per gallon cost would not necessarily be uniform throughout the industry, but could vary from company to company, depending on a number of considerations such as the inventory and sales factors discussed in Appendix 6-B.

## SALES TAX

6.13 Effective August 15, 1975, or at such time as prices change to reflect the July 1, 1975, increase in the price of crude oil, the industry's federal sales tax liability for petroleum products subject to federal sales tax will increase.6 cents per gallon. This is uniform throughout the industry.

## UNDER-REALIZATIONS

6.14 In highly competitive markets, the oil companies do not realize 100 percent of their listed wholesale prices. Average selling prices have been lower than listed prices. The difference between the actual average selling price and the listed price is known in the industry as an "under-realization".

6.15 In determining what its listed prices might be subsequent to the lifting of the price freeze, at least one company suggested that it will increase its listed prices by an amount that will enable it, if market prices permit, to ensure that it will in fact recover the full "$1.50 per barrel, adjusted for refining consumption and working capital carrying charges . . .". It is possible that companies will seek to increase their prices by amounts sufficiently higher than $1.50 per barrel to offset the under-realizations that they may expect under these prevailing market conditions.

6.16 It is important to note, however, that although a company may in fact increase its listed prices to take account of the under-realization factor, whether or not such increases will ever be reflected in actual selling prices is a matter of considerable conjecture. It is likely that the basis for the actual price decision is whatever the market will accept.

## RECOVERY OF CASH SHORT-FALLS

6.17 Two companies have indicated intentions to increase their listed prices by an amount that would enable them to recover within the next 12 months the estimated loss of sales revenue from the delay in implementation of posted product price increases in Ontario.

6.18 Any past inability to increase selling prices resulting from the Ontario price freeze does not affect refiners' marginal cost of producing additional barrels of petroleum products. These sales revenue losses or short-falls are past opportunity losses rather than current production costs. In a truly competitive market, refiners will not be able to "recover" or "amortize" such deficiencies. Only if each firm could assume that all others would add such a charge (i.e., if the industry were effectively monopolistic) could it realize these increases.

6.19 However, the statements by companies that they intend, or expect, to increase prices by a given amount, in order to recover short-falls, are not sufficient evidence that the industry is in fact uncompetitive, even though such a price increase is unrelated to changes in marginal costs or demand. Before this Commission, the companies rationalized price increases related to the short-falls on the basis of "costs".

6.20 Moreover, as in the case of the "under-realization" factor, it is very questionable that the desire to recover cash short-falls due to the extension of the price freeze will ever be reflected in actual selling prices. Again, marketing considerations are likely to govern the pricing decision.

## OTHER COST INCREASES

6.21 In addition to the cost increases directly and indirectly attributed to the increased price of crude oil, the companies for the most part claim to have incurred substantial recent cost increases in many other areas of their refining and marketing operations. The federal price guidelines, however, preclude the industry from increasing prices to compensate for these other cost increases at the same time as it increases prices in respect of increased crude costs. Consequently, most companies have not yet provided the Commission with any details as to their increased costs other than those directly or indirectly related to the increased price of crude oil. The Commission expects to explore these other cost increases in somewhat greater depth in the near future.

## PRICES AS BETWEEN PRODUCTS

6.22 To this point, the companies have indicated intentions of seeking to increase prices by more or less the same amount across all products. They have also, however, indicated that in the final analysis their pricing strategies will depend on market conditions at the time the price freeze is lifted. Several companies have indicated that, while they would like to increase prices uniformly across the board, in the case of heavy oils, which compete directly with substitutes, this may simply not be possible. Therefore, the companies may seek higher price increases for products with a relatively less elastic demand than those of heavy oils, in order to achieve full recovery of their increased costs.

# CHAPTER 7

## THE NEXT PHASE OF THE INQUIRY

7.1 This chapter reviews those matters that will be addressed in Phase II of the Commission's work. The work will be directed to:

(a) topics raised during Phase 1 that required further investigation;

(b) the last two items of the terms of reference.

### ONGOING TOPICS

7.2 Several trade associations, representing different sectors of the business community and listed in Appendix 2-C, presented briefs to the Commission and gave evidence at the hearings. The Commission is grateful to those associations for providing thoughtful views about the industry. To the extent that these points are within the terms of reference and are relevant to Phase I of the inquiry, they are reflected in the earlier portions of this report.

7.3 The salient points made by these associations are as follows.

(a) There is unfair price competition in the retail sale of gasoline because the major integrated companies are both suppliers to and competitors in the retail market.

(b) Oversupply or excess refining capacity, or some combination of these factors, and consequent competition for markets among the major companies cause price wars that are prejudicial to the independent operators of retail outlets.

(c) There are anomalies and possible abuses in the use by the companies of the posted tank wagon price for gasoline.

(d) The major companies subsidize or support certain of their dealers, in one way or another, in areas where price wars occur, but such price support still leaves the dealers bearing the worst consequences of the price wars.

(e) The existence of such subsidies or supports involves costs to the companies, and implies a profit "cushion" that should be utilized to offset a potential price increase.

(f) Increasing penetration by the major companies of the retail market, coupled with unfair price competition, threatens the existence of independent retailers, whose continued existence is necessary to a healthy retail market in gasoline.

(g) Long-term capital requirements of the petroleum industry should be met by raising debt or equity capital rather than out of current revenues.

7.4 One additional concern expressed by representatives of interests outside of the major petroleum companies was the effect of a price freeze on the independent dealer. These representatives contended that a freeze was more stringent on and prejudicial to these dealers than on the major companies. Without passing any comment on the accuracy of this contention, it is apparent that the effect of a price freeze on persons in such businesses, such as those carried on by independent dealers, has been to require them to absorb increasing costs at their own expense for the benefit of the general public. It seems reasonable to conclude that in businesses where the return on capital would appear to be modest at the best of times, the freeze has occasioned a real hardship for the proprietors. Whether they should bear this hardship, for the general purpose and in the general interest of cushioning consumers as a larger group from the effects of inflation, involves political considerations that are beyond the scope of this Commission.

7.5 A brief was presented to the Commission by Mr. Stephen Lewis, the leader of the New Democratic Party in Ontario. His brief gave evidence of much thought in preparation, and provided a useful impetus to the Commission, particularly in connection with the matters dealt with in Chapters 3, 4 and 5.

## MATTERS REMAINING

7.6 The second phase of the inquiry, leading to a final report, will deal primarily with items (c) and (d) of the terms of reference.

7.7 The Commission also intends to investigate regional price differentials throughout Ontario. For this purpose, public hearings will be held throughout the Province at such places as may be required.

7.8 With a view to making a balanced report on (d) of the terms of reference, the Commission will consult responsible officials of the Federal

Government and certain of the provinces regarding their experiences with the regulation and review of price increases. The Commission will be seeking additional evidence to assist in determining the relationship of the Government of Ontario to price changes in the oil industry that are most in the public interest.

* * * * *

7.9 The Commission would like to express its appreciation to many persons and organizations for their cooperation and contributions during the brief and intensive period of Phase 1. Representatives of Government, major petroleum companies, independent associations and consumer groups have all responded in an excellent manner and without complaint to tight deadlines. We extend our thanks to them, and look forward to their continuing cooperation and support in the next phase.

# ORDERS - IN - COUNCIL

Ontario

Executive Council

O.C. 1998/75

Copy of an Order-in-Council approved by Her Honour the Lieutenant Governor, dated the 16th day of July, A.D. 1975.

The Committee of Council have had under consideration the report of the Honourable the Premier, wherein he states that,

WHEREAS the supply and price of petroleum products in Ontario, existing and for the immediate future, is a matter of public concern;

The Honourable the Premier therefore recommends that, pursuant to the provisions of The Public Inquiries Act, 1971, a Commission be issued appointing, effective on and after the 1st day of August, 1975,

Claude Malcolm Isbister,
Toronto,

as Commissioner, such Commission being designated as The Royal Commission on Petroleum Products Pricing, and that the said Claude Malcolm Isbister be empowered and instructed to inquire into and report to the Lieutenant Governor in Council on or before the 30th day of September, 1975, on,

(a) inventories available to Ontario of crude oil and petroleum products;

(b) any changes (other than those directly attributable to changes in the price of crude oil) in the price of petroleum products sold in Ontario, within the meaning of The Petroleum Products Price Freeze Act, 1975, which may reasonably

occur after the 30th day of September, 1975, or such later date as is mentioned in any order of your Honour pursuant to subsection 2 of section 2 of the said Act;

(c) the relationship between any such price changes and the interests of the consuming public of Ontario, particularly, with consideration being given to,

- the adequacy of any petroleum product pricing guidelines established by the Federal Government as they may apply to Ontario;
- working capital requirements of the petroleum industry;
- the continuity of supply in Ontario of crude oil and more particularly petroleum products;

(d) consideration as to procedures that might be followed in relation to future changes in the price of crude oil;

The Honourable the Premier further recommends that, pursuant to the said Public Inquiries Act, 1971, the said Commissioner have the power of summoning any person and requiring him to give evidence on oath and to produce such documents and things as the Commissioner deems requisite for the full investigation of the matters into which he is appointed to examine.

And the Honourable the Premier further recommends that all government ministries, boards, agencies and committees assist to the fullest extent the said Commissioner who, in order to carry out his duties and functions, shall have the power and authority to engage such staff, secretarial and otherwise, and technical advisors, as he deems proper, at rates of remuneration and reimbursement to be approved by the Management Board of Cabinet, and to pay reasonable compensation as approved by the Management Board of Cabinet for any expenses incurred in furtherance of the purposes of this inquiry prior to the 1st day of August, 1975.

The Committee of Council concur in the recommendations of the Honourable the Premier and advise that the same be acted on.

Certified,

D. C. Mowat

Acting Clerk, Executive Council.

Ontario

Executive Council

O.C. 2126/75

Copy of an Order-in-Council approved by Her Honour the Lieutenant Governor, dated the 6th day of August A.D. 1975.

The Committee of Council have had under consideration the report of the Honourable the Premier, wherein he states that ORDER-IN-COUNCIL NUMBERED OC-1998/75, made by Your Honour on the 16th day of July, 1975, in respect of the second paragraph of the Preamble thereto, be amended,

(i) by deleting "on or before the 30th day of September, 1975" from the eleventh line thereof;

(ii) by adding at the end of clause (a),

"on the 4th day of July, 1975 and likely to be available on the 30th day of September, 1975 and on such other times as the Commissioner may deem relevant to his Inquiry";

(iii) by inserting in the seventh line of clause (b) at the top of page two immediately after the word "occur" the word "following" and in the eighth line immediately after the word "or" the word "following";

(iv) by deleting the period at the end of clause (d) and substituting therefor a semicolon and by adding after clause (d),

"and that the Commissioner submit a first report not later than the 30th day of September, 1975 and a final report as soon as practicable thereafter",

so that as amended the second paragraph of the Preamble reads as follows:

"The Honourable the Premier therefore recommends that, pursuant to the provisions of The Public Inquiries Act, 1971, a Commission be issued appointing, effective on and after the 1st day of August 1975,

Claude Malcolm Isbister,
Toronto,

as Commissioner, such Commission being designated as The Royal Commission on Petroleum Products Pricing, and that the said Claude Malcolm Isbister be empowered and instructed to inquire into and report to the Lieutenant Governor in Council, on,

(a) inventories available to Ontario of crude oil and petroleum products on the 4th day of July, 1975 and likely to be available on the 30th day of September, 1975, and on such other times as the Commissioner may deem relevant to his Inquiry;

(b) any changes (other than those directly attributable to changes in the price of crude oil) in the price of petroleum products sold in Ontario, within the meaning of The Petroleum Products

Price Freeze Act, 1975 which may reasonably occur following the 30th day of September, 1975, or following such later date as is mentioned in any order of Your Honour pursuant to subsection 2 of section 2 of the said Act;

(c) the relationship between any such price changes and the interests of the consuming public of Ontario, particularly, with consideration being given to,

- the adequacy of any petroleum product pricing guidelines established by the Federal Government as they may apply to Ontario.

- working capital requirements of the petroleum industry;

- the continuity of supply in Ontario of crude oil and more particularly petroleum products;

(d) consideration as to procedures that might be followed in relation to future changes in the price of crude oil;

and that the Commissioner submit a first report not later than the 30th day of September, 1975 and a final report as soon as practicable thereafter".

The Committee of Council concur in the recommendation of the Honourable the Premier and advise that the same be acted on.

Certified,

J. J. Young

Clerk, Executive Council.

## COMMISSION STAFF AND ADVISORS

| | |
|---|---|
| William J. Anderson, Q.C. | Counsel |
| Neil E. Paget | Secretary |
| Graham W. Wright, C.A. | Accounting Advisor |
| George Brydon | Technical Advisor |
| Stuart J. Campbell | Assistants |
| David Hull, C.A. | |
| Casimiro A. Maiocco | |
| A. Michael Spence | Special Advisors |
| Arlon R. Tussing | |
| Leonard Waverman | |
| Andria Hourwich | Editor |
| Regina Stuart | Office Manager |

## PERSONS APPEARING AT PUBLIC HEARINGS OF THE COMMISSION

BP CANADA LIMITED

D.A. Deverell, Vice-President, Marketing
J.A. Barclay, Vice-President, Supply and Refining
J.L. McDougall, Counsel
D.A. Jack, Counsel

CANADIAN CARWASH ASSOCIATION

Hugh M. Brown
Charles A. Graham
Ian W.M. Angus, Counsel

CANADIAN FEDERATION OF INDEPENDENT BUSINESS

James R. Conrad, Director, Policy and Research
Reuben M. Bromstein, Counsel

CONSUMERS' ASSOCIATION OF CANADA (ONTARIO)

John Wilson, Executive Director

COMFORT FUELS DIVISION OF COMFORT HOLDINGS LIMITED

Barry Ganz

GULF OIL CANADA LIMITED

C.G. Walker, Vice-President
W.H. Griffen, Director of the Motorist Market
J.A. Scobie, Comptroller
Richard F. Moyse, Manager of Services
David D. Archibald, Counsel

IMPERIAL OIL LIMITED

J.W. Flanagan, Vice-President
D.M. Penrose, Manager, Petroleum Products Coordination
G.R. Wisener, Assistant General Manager
H.G. Batt, Q.C., Counsel
W.H.E. Urquhart, Q.C., Counsel

ONTARIO NEW DEMOCRATIC PARTY

Stephen Lewis, Leader of the New Democratic Party of Ontario
James Renwick, Q.C., Counsel

ONTARIO RETAIL GASOLINE & AUTOMOTIVE SERVICE ASSOCIATION

James H. Stanford
William J. Burkimsher
Robert N. Pyke
Reuben M. Bromstein, Counsel

PETROFINA CANADA LTD.

H.S.W. Williams, Division Manager
J.P. Gaffney
John Sopinka, Q.C., Counsel
R.W. Cosman, Counsel
Norman R. Lemyre, Counsel

PROPANE GAS ASSOCIATION OF CANADA, INC., ONTARIO COMMITTEE

R.G. Samworth

SHELL CANADA LIMITED

G.A. Bevan, Vice-President, Marketing
C. Kappler, Manager, Retail Operations
T.B.O. McKeag, Q.C., Counsel
B.I. Mactaggart, Counsel

SUN OIL COMPANY LIMITED

Harry S. Ostrander, Vice-President, Products
G.H. Brereton
B.T. Abbott
K.T. Knox
J.R. Houston, Q.C., Counsel
B.B. Campbell, Counsel

TEXACO CANADA LIMITED

Harry T. Hudson, Vice-President and Treasurer
A.J. Galipeault, Counsel
M.P. Laperriere, Counsel

| Product Category | Description |
| --- | --- |
| Motor gasolines .................... | All gasoline type fuels for internal combustion engines other than aircraft |
| Aviation turbo fuels ................ | All fuels for turbo-jet or straight jet aircraft engines |
| Stove oil and kerosene .............. | Distillate type kerosene<br>Kerosene<br>Mineral lamp oil<br>No. 1 fuel oil<br>Stove oil (including all vapourizing burner oil) |
| Diesel fuel oil ..................... | All grades of distillate fuel sold for diesel engine use |
| Light fuel oil ...................... | All distillate type fuels for power burners<br>Fuel oil No. 2 (heating oil No. 2)<br>Fuel oil No. 3 (heating oil No. 3)<br>Furnace fuel oil<br>Gas oils<br>Light industrial fuel |
| Heavy fuel oil ...................... | All grades of residual type fuels (including low sulphur) for both steam and diesel engines<br>Bunker fuel oil (including bunker A, B and C)<br>Fuel oils Nos. 4,5 or 6<br>Residual fuel oil |

Source - Statistics Canada, Catalogue No. 45-208

## INVENTORIES AVAILABLE TO ONTARIO

The definition of "inventories available to Ontario" includes:

(a) inventories physically in Ontario;

(b) inventories destined for Ontario; i.e., outside but in transit to Ontario.

The inventories physically in Ontario comprise all crude oil, refinery unfinished inventories and finished products in Ontario (including pipeline fill, refinery base stocks, unavailable tank bottoms, inventories in transit, at agencies and in service stations, where considered significant). The crude oil and refinery unfinished inventories have been converted to their finished product equivalents on a basis consistent with the actual or forecast operations within the industry.

The inventories destined for Ontario include all inventory from external supply sources, such as:

(a) out-of-province refinery and terminal finished products;

(b) out-of-province refinery crude oil and unfinished inventories;

(c) crude oil and imported products (domestic and foreign) contracted for, and in transit to Ontario.

The unfinished inventories and crude oil were converted to their finished product equivalents. A portion of the total inventory in the supply network was allocated to Ontario on the basis of actual or forecast distribution problems within the industry.

## DETAILED BACK-UP ON INVENTORY SUPPLIES

The information on inventories presented in this report was gathered from ten major companies of the oil industry in Ontario These include:

BP Canada Limited

Canadian Fuel Marketers Ltd.

Golden Eagle Canada Limited

Gulf Oil Canada

Imperial Oil Limited

Murphy Oil Company Ltd.

Petrofina Canada Ltd.

Shell Canada Limited

Sun Oil Company Limited

Texaco Canada Limited

These companies were requested to report totals of all inventories to which they had title, by product, as of four dates:

September 30, 1975

June 30, 1975

September 30, 1974 and

June 30, 1974 - chosen for purposes of comparison.

In addition to the inventory levels, each reporting company was asked to calculate by product, on the basis of actual or forecast sales in the period following each relevant date, the number of days supply its reported inventory represents.

ESTIMATED INVENTORIES AVAILABLE TO ONTARIO

| PRODUCTS | September 30, 1975*** | | | | June 30, 1975 | | | | September 30, 1974 | | | | June 30, 1974 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Barrels (thousands) | Days Supply* | | | Barrels (thousands) | Days Supply* | | | Barrels (thousands) | Days Supply | | | Barrels (thousands) | Days Supply* | | |
| | | Ave | Low | High | | Ave | Low | High | | Ave | Low | High | | Ave | Low | High |
| Propane | 400 | 59 | 33 | 90 | 300 | 62 | 46 | 84 | 300 | 60 | 24 | 109 | 300 | 56 | 21 | 70 |
| Motor Gasoline | 16,500 | 74 | 6 | 134 | 17,500 | 72 | 30 | 94 | 15,600 | 74 | 21 | 97 | 17,000 | 75 | 15 | 96 |
| Aviation Jet Fuel | 1,800 | 87 | 49 | 97 | 2,000 | 71 | 45 | 100 | 1,300 | 76 | 44 | 144 | 1,700 | 73 | 63 | 147 |
| Middle Distillates** | 23,900 | 122 | 8 | 153 | 19,200 | 169 | 32 | 184 | 22,600 | 118 | 36 | 140 | 16,000 | 153 | 39 | 159 |
| Heavy Fuel Oil | 6,400 | 71 | 30 | 176 | 6,000 | 96 | 19 | 173 | 6,200 | 78 | 55 | 146 | 5,500 | 95 | 35 | 134 |
| Total Barrels | 49,000 | | | | 45,000 | | | | 46,000 | | | | 40,500 | | | |
| Days Supply | | 91 | 30 | 120 | | 107 | 30 | 180 | | 91 | 45 | 115 | | 102 | 30 | 140 |

* - The basis for calculation of average days supply figures (as explained in Notes 2 and 3 to this appendix) is "domestic disappearance" ("net sales" for heavy fuel oils) from Table 3 of Statistics Canada, catalogue No. 45-004. The low/high range of days supply shown above is taken from figures submitted to the Commission.

** - Includes:
- Stove oil
- Diesel fuel oil
- Light (furnace) fuel oil

*** - Inventory figures for September 30, 1975 are forecasts prepared by the reporting companies

Further notes on inventories and days supply are included in Notes 1 to 3 to this appendix.

Notes to Appendix 4-B

SUMMARY OF INVENTORIES AVAILABLE TO ONTARIO

Inventory Totals

1. In presenting the above inventory totals, the Commission would like to stress the following points.

(a) The totals are compiled from returns submitted to the Commission by the reporting companies; there are inventories held by other companies, agents and dealers that the Commission is satisfied would not materially affect the data presented here.

(b) The products on which the Commission has reported are those subject to The Petroleum Freeze Act, 1975 and therefore such petroleum products as lubricating oils, greases, chemical feeds and asphalt are not included.

(c) The quantities of crude oil and refinery unfinished inventories reported to the Commission were expressed in terms of their finished product equivalents, after allowing for net consumption in the refining process and production of those refined petroleum products not required by the Commission.

Days Supply

2. The figures for number of days supply presented in this Appendix are from two sources.

(a) The reporting companies submitted to the Commission the number of days supply represented by the inventories of each product at the four relevant dates. The days supply figures were calculated by applying actual or forecast sales of the products, in the period immediately following the relevant dates, against the reported inventory of that product.

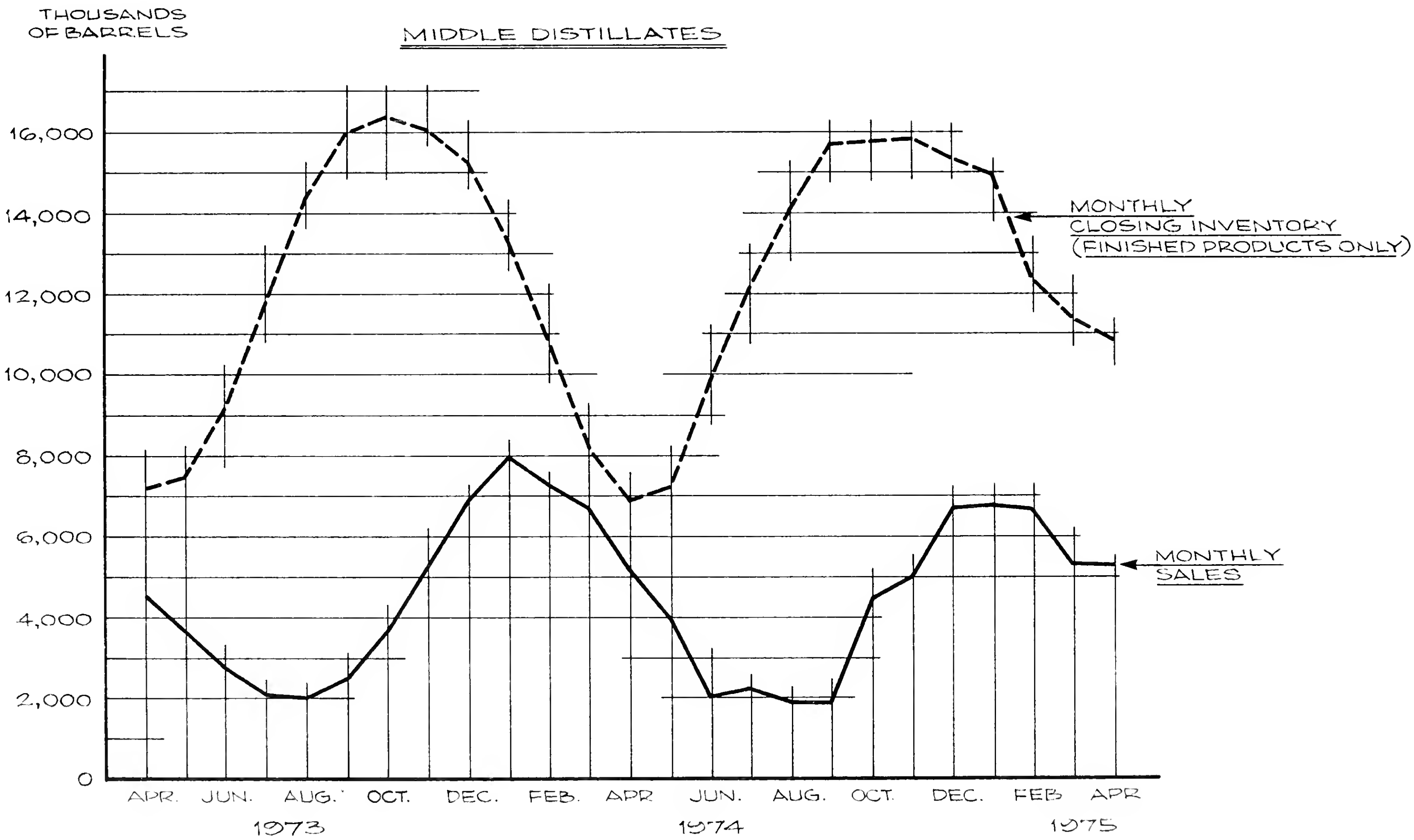
(b) Number of days supply represented by the total inventories of each product and the overall total inventories were calculated by the Commission. The calculations for 1974 were made by applying demand figures from Statistics Canada (catalogue No. 45-004, Table 3 - "Domestic Disappearance") against reported inventory totals. Forecast demand figures for 1975 were estimated from their 1974 equivalents.

3. The Commission recognized that the above approach will produce, at best, approximate numbers of days supply. The method of calculation assumes that demand within any one month is linear, and that demand is transferable between products and companies. Although neither assumption is entirely accurate for the oil industry as a whole, it is fair to use average days supply figures to calculate the financial implications of a price freeze.

SALES AND INVENTORY LEVELS

MIDDLE DISTILLATES

April 1973 to April 1975




SOURCE - STATISTICS CANADA, CAT. NO. 45-004, TABLE 3

# FEDERAL PRICE GUIDELINES

Telex of the Minister of Energy, Mines and Resources to the Canadian Oil Industry - February 21, 1975

1. I am appreciative of the industry's positive response to the Federal Government's successive requests for price restraint.

2. Since September 1973 when the voluntary price restraint was instituted, the industry's price behaviour has generally justified the application of flexibility inherent in the government's price guidelines. The Canadian consumer benefited greatly from this program during a period of fundamental changes in market conditions.

3. Companies may now reflect in their product selling prices changes in non-crude costs experienced since September 1973, to the extent that these changes have not already been offset by revenue and/or productivity improvements, as well as by the price increases authorized last May 15.

4. Adjustments are to be made in general relation to where cost increases have been experienced and not in relation to the relative strengths of competition. For example, products sold ex-refinery should reflect increases in refining costs only. Sales that have been affected as well by an increase in marketing costs should bear commensurate adjustments.

5. At the same time that any cost-increase price-adjustments are made under these guidelines, companies may make any changes in selling prices needed to remove anomalies in inter-product price, price zone and/or trade class relationships which are inevitable under a price restraint program.

6. Officials in my department will continue to monitor product selling prices across Canada. Companies have to be prepared to explain any unusual changes made under four and five above. Should abuse occur there will be a return to administered pricing.

Telex of the Minister of Energy, Mines and Resources to the Canadian Oil Industry - July 14, 1975

1. I wish to formally convey to you the Government's request that the oil industry refrain from oil product price increases for a period of 45 days following the July 1 rise in Canadian crude oil prices and the related decrease in import compensation.

2. Effective August 15, wholesale prices of oil products excluding federal sales tax may be increased in such a way that potential cost recovery will not exceed $1.50 per barrel, adjusted for refinery consumption and working capital carrying charges resulting from the deferral of crude cost increase flow through.

3. Companies affected by additional cost increases resulting from changes in the design of the Oil Import Compensation Program may seek to recover these by means other than increases in posted prices.

4. The recovery of any other cost changes, such as increased refining and marketing operating expenses, should not be attempted in conjunction with price increases associated with the $1.50 rise in crude costs.

5. Companies are requested to announce their posted price increases, regardless of the effective date by the close of business, July 15.

6. The Department of National Revenue will evaluate the price increases announced pursuant to this release with the objective of revising the affected tax reference values for implementation simultaneously with the product price changes related to the crude cost increase.

## ADDITIONAL FINANCING REQUIRED TO OFFSET THE INCREASE IN THE PRICE OF CRUDE OIL

The amount of new capital required in the refining and marketing operations to finance any increase in the cost of crude oil is a function of a number of different variables, and will vary from company to company. The key factors that normally determine the amount of increased capital required by any company are:

(a) The amount of inventory on hand

(b) The company's accounts receivable collection experience - i.e. the number of days sales included in accounts receivable

(c) The company's accounts payable experience - i.e. the number of days purchases normally financed by its suppliers.

In general, the more inventory on hand, the higher the number of days sales in accounts receivable and the fewer days of purchases financed by suppliers, the greater the increased capital required to finance any raw material price rise. Conversely, the smaller the inventory, the fewer the days of sales in accounts receivable and the greater the amount of purchases financed by suppliers, the smaller the amount of new capital required to finance any raw material price rise.

Requirements for capital to finance an increase in the cost of crude oil are further affected by:

(a) The amount and timing of any offsetting finished product price increases - i.e., increases in the prices the company gets for its products

(b) The company's effective marginal income tax rate

(c) Whether or not the company has "excess" inventory on hand at the time of the cost increases. The company can reduce financing problems attached to the "excess" portion of inventory at the time raw material costs increase, to the extent that it subsequently reduces inventory to a more normal level.

Generally, cost increases passed on to customers within a period equal to or less than the number of days supply of inventory on hand at the time of a raw material price increase will not affect the amount of new financing required, but will affect profits after taxes, and the availability of internal funds. However, a company will require additional financing to the extent that it cannot reflect raw material cost increases in comparable increases in selling prices for a period of time longer than the number of days supply of inventory on hand at the time of the cost increase. New capital will be required to cover not only increased working capital carrying costs, but also the continuing higher raw material costs not recovered via increased selling prices.

It is not the Commission's intent at this time to suggest that changes in working capital should be financed either through internal profits or external borrowing. However, it is important to understand the effect that the timing of selling price increases has on the internal-external financing issue. This appendix provides the background calculations on four different approaches:

(a) Selling prices are increased on the same day that crude prices rise

(b) Selling prices are increased 45 days after crude prices rise

(c) Selling prices are increased 90 days after crude prices rise

(d) Selling prices are increased 135 days after crude prices rise.

Throughout these calculations, the following basic assumptions apply:

(a) Number of days sales in accounts receivable 52 days whereas number of days purchases in accounts payable = 40 days

(b) Normal inventory = 45,000,000 barrels of crude oil and equivalent finished products, which is approximately equal to 105 days supply

(c) Daily demand is constant

(d) The amount of any price increase is only sufficient to offset the increased cost of crude oil

(e) Increased cost of crude oil = $1.50 per barrel

(f) The Ontario refining and marketing operations of the oil companies have a 50% marginal income tax rate.

1. Selling prices increase on same day cost of crude oil rises:

| | |
|---|---|
| Increased inventory (45,000,000 x $1.50) | $67,500,000 |
| Increased accounts receivable in excess of increased accounts payable (rounded to nearest $500,000) $(12 \times \frac{45,000,000}{105} \times \$1.50)$ | 7,500,000 |
| | $75,000,000 |
| "Inventory profit" | $67,500,000 |
| Income taxes thereon | 33,750,000 |
| Financing provided from after-tax "inventory profits" | 33,750,000 |
| Required outside financing | 41,250,000 |
| | $75,000,000 |

2. Selling prices increase 45 days after crude oil price rises:

| | |
|---|---|
| Increased inventory | $67,500,000 |
| Increased accounts receivable less increased accounts payable | 7,500,000 |
| | $75,000,000 |
| "Inventory profit" (rounded to nearest $500,000) | 38,500,000 |
| Income taxes thereon @ 50% | 19,250,000 |
| Financing provided out of after-tax "inventory profits" | 19,250,000 |
| Required outside financing | 55,750,000 |
| | $75,000,000 |

3. <u>Selling prices increase 90 days after crude oil price rises:</u>

| | |
|---|---|
| Increased inventory | $67,500,000 |
| Increased accounts receivable less increased accounts payable | 7,500,000 |
| | $75,000,000 |
| "Inventory profit" (rounded to nearest $500,000) | 9,500,000 |
| Income taxes thereon | 4,750,000 |
| Financing provided out of after-tax "inventory profits" | 4,750,000 |
| Required outside financing | $70,250,000 |
| | $75,000,000 |

4. <u>Selling prices increase 135 days after crude oil price rises:</u>

| | |
|---|---|
| Increased inventory | $67,500,000 |
| Increased accounts receivable less increased accounts payable | 7,500,000 |
| | $75,000,000 |
| Increased costs not passed on in increased selling prices (rounded to nearest $500,000) | $19,500,000 |
| Income tax savings | 9,750,000 |
| Increased after-tax costs not passed on in increased selling prices | 9,750,000 |
| Required financing to cover all of the above | $84,750,000 |